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The Dollar is Our Currency, but It's Your Problem:
Rebalancing Requires a Much Weaker USD

Today is not the first time a sitting U.S. president has sought a weaker greenback to rebalance the economy. The 'Nixon shock' in 1971 induced a 20% weaker USD, with Treasury Secretary Connally announcing to his G10 counterparts, "The dollar is our currency, but it's your problem."[1] A second precedent is the Plaza Accord of 1985, piloted by President Reagan and Treasury Secretary Baker, which delivered a 25% decline in the greenback.

Today's backdrop bears numerous similarities to 1971 and 1985. For a start, the USD has appreciated by 30% since 2010 and is undeniably over-valued. In addition, the U.S. economy suffers from a massive trade imbalance, which is unsustainable and, until recently, deteriorating even further. Finally, a transformational president believes America is on the wrong track and strives to usher in a new global economic order. Bottom-line: Similar to Nixon and Reagan, Trump believes America cannot rebalance trade without a dramatically weaker currency.

There are two key risks to our bearish USD view. First, that the U.S. continues to attract enormous capital inflows, either because of AI or the nascent stablecoin boom. Second, that Trump abandons his aspirations for balanced trade and reshoring. This could reflect a shortage of skilled workers, overwhelming supply chain complexity, political resistance, or just the president's lack of patience.[2]

While acknowledging these risks, our base-case view is that we are in the early innings of an economic rebalancing, that cannot succeed without a dramatically weaker USD. The next down-leg in the dollar will likely occur when the White House's emphasis pivots from tariffs and trade deals toward the policies advocated by

[1] "The Dollar is our Currency, but it's Your Problem," Investment & Pensions Europe, 2007.

[2] The vast majority of investors we have spoken with are highly skeptical regarding reshoring, reindustrialization and reducing trade imbalances. We understand the reasons for such skepticism but have adopted a more optimistic take. Please see, "The New Global Order: Implications for Investors," April 2025.

Stephen Miran, chair of the Council of Economic Advisors (CEA). Such policies could include capital flow restrictions, debt swaps, establishing a sovereign wealth fund (SWF), closer coordination with the Fed, and a Mar-a-Lago Accord.

After having appreciated for fifteen years, what would a soft dollar mean for investors? We expect higher foreign exchange (FX) volatility, with two-way USD risk and a weakening bias. CAD-based investors generally own a lot of USD-assets, but typically under-hedge their currency exposure. This represents a lot of risk, for which they are unlikely to be compensated. Investors may consider adopting a deliberate approach to hedging.

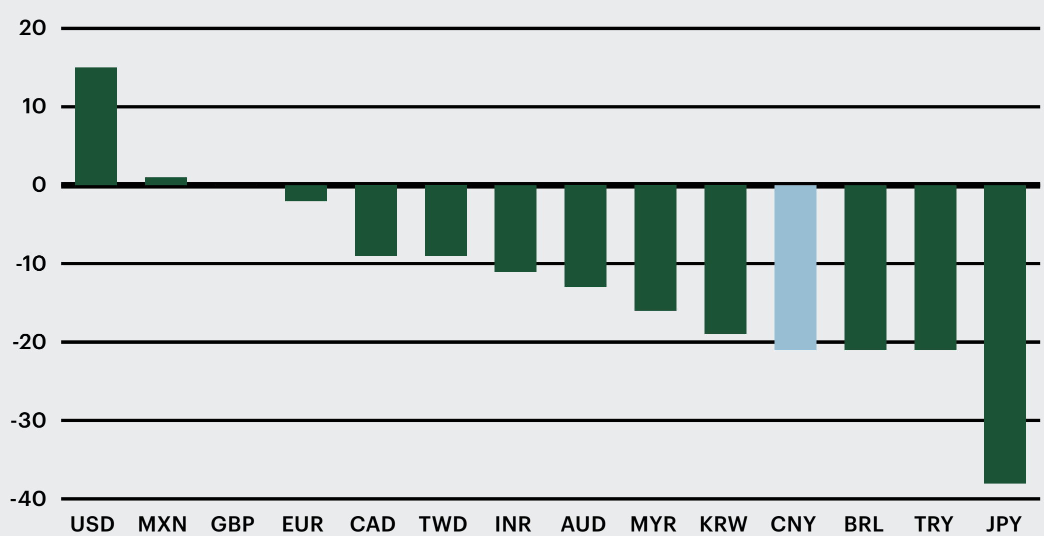
The remainder of this paper begins by explaining the four reasons why we expect a weaker greenback. This discussion includes implications for the CNY and bond yields. We then examine what this means for sectors within the S&P 500, as well as equity regions globally. A softer USD corresponds to a loosening of financial conditions which disproportionately benefits cyclical sectors (such as materials, industrials and energy) and regions (particularly emerging markets and the EU). Next, we discuss hedging and conclude with implications for investors.

1) Valuations: USD is 10% to 20% expensive

The first reason why we expect a softer dollar is that all approaches to currency valuation agree the greenback is over-valued. We examined a variety of metrics and find the countries with the cheapest currencies include Japan and China **(Figure 1)**. President Trump frequently insists the JPY and CNY are manipulated to make their economies more competitive and the U.S. less so. On this point, take him both seriously and literally.

The challenge is that currencies, just like equities, can remain misvalued for years. However, once there is a shift in policy direction or market fundamentals, valuations can swiftly adjust. This leads us to the second argument for a weaker greenback, the world is awash in USD assets.

Figure 1: The USD is 15% overvalued, while undervalued currencies include the JPY (38%) and CNY (21%)



Source: International Monetary Fund, World Bank, Bloomberg Finance L.P.

Note: The table presents an average of five different valuation measures, including REER (real effective exchange rate) and PPP (purchasing power parity).

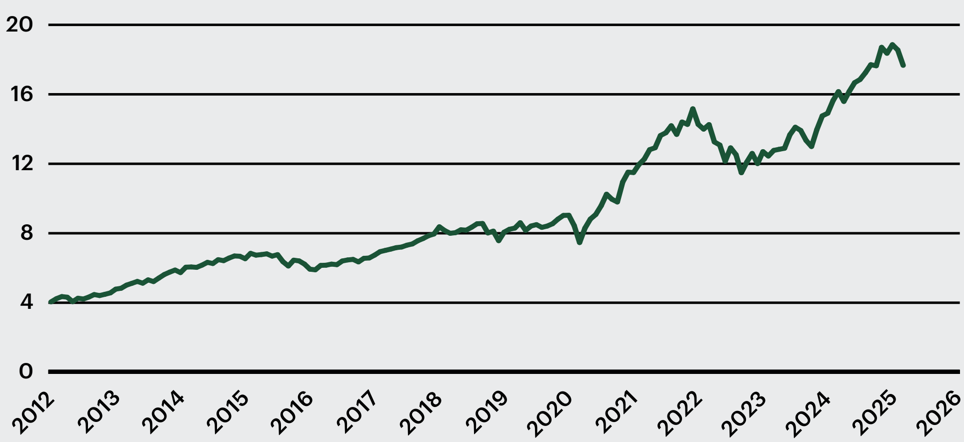
2) It is hard to overstate the dominance of the dollar globally: USD assets are over-owned by foreign investors

At end of 2024 there were three notable long positions in markets: the Magnificent 7, U.S. equities and the USD. This was the culmination of years of bulking up on USD assets. To illustrate, the foreign ownership share of U.S. equities increased from 5% in 1995 to 20% today. The value has soared from $4 tn in 2012 to $18 tn currently **(Figure 2)**. Foreigners also own 30% of both U.S. Treasuries (USTs) ($7.2 tn) and corporate credit ($4.6 tn).

More broadly, it is hard to overstate the dominance of the dollar globally. The USD holds a 79% share of global trade finance (vs 7% for EUR and 8% for RMB), a 47% share of cross border loans (30% for EUR and de minimus for RMB), 48% of Swift payments (24% EUR and 3% RMB), 58% of FX reserves (20% EUR and 2% RMB) and 88% of FX transaction volume (31% EUR and 7% RMB; note the total sums to 200%).

It is likely that USD dominance and foreign ownership has peaked. The risk to this view is that the U.S. continues to attract enormous capital inflows, either because of AI or the nascent stablecoin boom. Regarding the latter, in July the U.S. passed the GENIUS Act, which creates a regulatory framework for stablecoins. Currently, 99% are USD-based and collateralized by U.S. Treasury bills, with consensus expecting an increase from $250 bn today to $1.5 tn by 2030. This could represent a moderate tailwind for the USD.

Figure 2: Foreign ownership of U.S. equities (USD tn), more than quadrupled since 2012



Source: U.S. Treasury, Federal Reserve Board

3) America's imbalances: Unsustainable and deteriorating even further

The United States has run current account deficits now for five decades, and these have widened precipitously in recent years … And this has happened all while the dollar has appreciated, not depreciated!

– Steve Miran, Chair, Council of Economic Advisors, April 2025[3]

The third reason to expect a weaker USD is that America faces a triple whammy of stubborn deficits. The first concerns trade, where the deficit has surged since 2000 **(Figure 3)**. Unsurprisingly, this is a mirror image of China's $1 tn surplus. The White House (WH) repeatedly emphasizes that China manufactures and exports goods, which we pay for by issuing USTs, with the dire result of deindustrialization and indebtedness.

[3] https://www.whitehouse.gov/briefings-statements/2025/04/cea-chairman-steve-miran-hudson-institute-event-remarks/

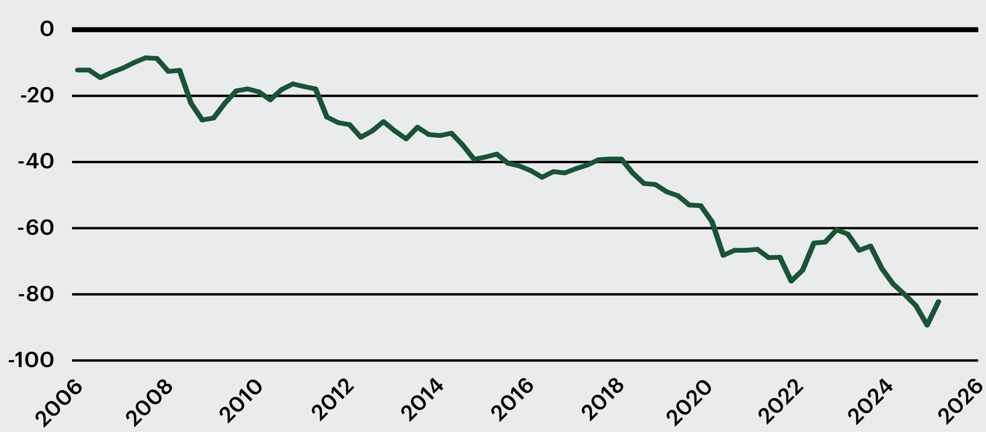
Figure 3: America's trade deficit is over $1 tn. A far weaker USD is required to reverse this trend and move towards balance.

Source: Bloomberg Finance L.P.

America is a massive net debtor to the rest of the world, currently to the tune of $26 tn or 80% of GDP **(Figure 4)**. This second imbalance follows directly from the first, through the balance of payments identity. We buy more imports than we export, with the surging gap paid for by selling claims on our future income (i.e., USTs). The WH stresses that we have been passively importing China's mercantilist policies, so that our net international investment position (NIIP, includes stocks, bonds, loans, foreign direct investments, and reserve assets) keeps deteriorating. It is no shocker that China has by far the largest surplus ($5.0 tn), followed by Japan ($3.6 tn) and Taiwan ($1.4 tn).

The third imbalance concerns the federal budget deficit, which is $1.9 tn or 6.2% of GDP. This percentage is the highest ever ex-war/recession. Equally worrisome, the Congressional Budget Office (CBO) expects the deficit to clock in at 6.1% of GDP in 2035 (optimistically assuming no recessions or new wars begin during the interim). That is, with the current policy mix, we are likely to make zero progress over the next decade in reducing the

Figure 4: The U.S. net international investment position (% GDP). It now exceeds 80% of GDP, up from 12% two decades ago.



Source: Bloomberg Finance L.P.

deficit. Reflecting this, federal debt is an astonishing $29 tn or 100% of GDP, up from 35% in 2007, and undeniably headed higher.

If these three imbalances are truly unsustainable, and this is clear to everyone, then why do market forces allow them to continue, and at such low interest rates? Steve Miran argues the key is the insatiable demand for USTs by mercantilist countries like China. They buy USTs to keep their currencies undervalued, effectively subsidizing domestic manufacturers and exporters. If the U.S. remains passive, and doesn't respond with policies of its own, the inevitable result is a strong greenback, deindustrialization, massive trade deficits, and a deteriorating NIIP.

Further, Miran asserts that foreign demand for USTs means federal deficits can always be financed, removing discipline from the budgeting process. America's #1 export becomes USTs and rather than being an exorbitant privilege, the USD's reserve currency status is best interpreted as an exorbitant burden.[4] This leads us to the final reason to expect a softer greenback.

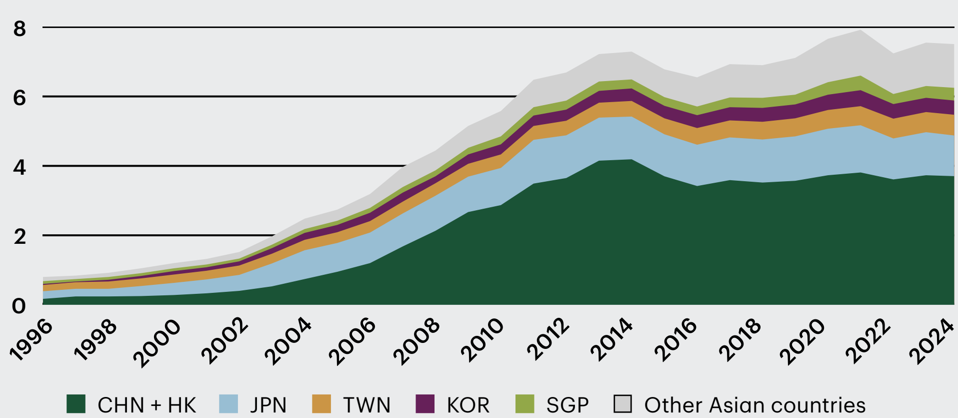
4) Mar-a-Lago Accord: White House wants a 'New Global Economic Order,' facilitated by a markedly weaker USD

The root of the economic imbalances lies in persistent dollar overvaluation that prevents the balancing of international trade, and this overvaluation is driven by inelastic demand for reserve assets.

– Steve Miran, April 2024[5]

There has been an insatiable foreign demand for USTs ever since China entered the WTO in 2001. This reflects mercantilist policies by China and several other countries, intervening to keep their domestic currencies undervalued. This is illustrated by Asian FX reserves which have soared to $7.5 tn and consist primarily of USD assets **(Figure 5)**.[6]

Figure 5: Asian countries' FX reserves (USD tn). Have surged over the last 25 years.



Source: World Bank, International Monetary Fund

[4] Economists refer to this as the Triffin Dilemma (named after a Belgian-American economist in the 1960s), which highlights the challenges associated with hosting the world's reserve currency. It can also be viewed as a variant of the Dutch Disease or natural resource curse.

[5] "A User's Guide to Restructuring the Global Trading System," by Steve Miran, 2024 (written before he joined the White House).

[6] Brad Setser argues China's reserves have been deliberately understated since 2014. Backdoor intervention includes delegating operations to state-owned banks, using foreign custodians (Belgium/Euroclear) and purchasing USD assets other than USTs. See for example, https://www.cfr.org/blog/case-china-now-actively-resisting-pressure-yuan-appreciate and https://www.cfr.org/blog/chinas-stealth-trade-surplus.

FX reserve assets are purchased to put upward pressure on the USD, which poses a major challenge for an administration that wants to balance trade and bring manufacturing jobs home. The WH is especially targeting the policies of China, as it is by far the biggest contributor to global imbalances. Further, Trump's economic advisors want to create a new global economic order, in which countries no longer have unconditional access to the U.S. consumer, security umbrella, or USD-based global financial system.

What does conditional access mean and how will the U.S. incentivize trading partners to start paying their fair share? In step one, which kicked into high gear on 'Liberation Day', the WH's policy toolkit focused on the real economy, including tariffs and trade deals. It appears to have elicited promises from trading partners to open their markets, build factories in the U.S. and increase their defense spending (with a significant share procured from American companies).

Step two, which is still in the planning phase, will include a new set of tools that are focused on the monetary economy and financial flows. These could include capital flow restrictions, debt swaps, FX intervention and creating a SWF.[7] Miran emphasizes that such policies are untried at scale and have not been used in almost half a century in the U.S.

Policies explicitly designed to weaken the USD could result in significant market volatility, which is why Miran stresses the importance of proceeding in 'baby steps', providing extensive forward guidance and reassuring investors that America will remain the primary reserve provider.[8] It is also possible that the Fed could work more closely with the Treasury to help implement these policies and mitigate market volatility.

Can the USD weaken even if Beijing keeps intervening to preserve CNY undervaluation?

Earlier we noted that valuation metrics suggest the CNY is 21% cheap (Figure 1). Further, given China's centrality to global trade, it is nigh impossible for the trade-weighted USD to depreciate sufficiently without significant CNY gains. In fact, this is the biggest challenge to a multilateral Mar-a-Lago Accord.

There are two reasons why Beijing continues to intervene. First, a weak RMB is critical to Beijing's mercantilist policy. And while appreciation would help China's economy rebalance toward consumption, Beijing is doubling down on exports (hence the second China shock highlighted in Figure 3).

Second, Beijing is determined to not repeat Japan's disastrous mistake from 1985 to 1995. Following the Plaza Accord, the JPY appreciated 211% vs USD and 84% on a REER basis. Japan's competitiveness collapsed, it entered the "lost decade(s)" and is still struggling to redefine its growth strategy.

> **If you've got a bazooka, and people know you've got it, you may not have to take it out.**
>
> **– Hank Paulson, Treasury Secretary, 2008**

If Beijing keeps intervening unilaterally to prevent CNY appreciation, what options does the U.S. have? One possibility is to discuss in the context of trade negotiations. For example, if Beijing allowed CNY to appreciate by x%, America could reduce tariffs on imports from China proportionately. A second option is to assert that D.C. has as much right to intervene in setting USD/CNY as Beijing does. However, markets would certainly test the Treasury's resolve, so this threat would only be credible if backed by a massive balance sheet, a 'big bazooka' if you will. And this would likely require closer cooperation with the Fed.

Would a weaker USD drive UST yields higher?

Many investors worry that WH policies designed to weaken the USD could drive UST yields markedly higher. This is an understandable concern as economists estimate primary reserve status has resulted in somewhat lower UST yields, in the region of 25 to 75 bps. However, the USD is not about to give up its reserve status and the two most comparable historical episodes suggest a benign outcome. In particular, UST yields actually declined

[7] Several prominent economists have also been writing in favor of these policies, including "Why Restrictions on Capital Flows Should be Considered," by M. Pettis, FT, July 2025. He stresses that the global role of the USD exacerbates domestic imbalances and deindustrialization, that primary reserve status is an exorbitant burden rather than a privilege, and taxing capital inflows will reduce trade deficits but not raise interest rates.

[8] Trump has repeatedly affirmed that the USD will remain #1, he just wants the reserve system to be made fairer, so that America can rebuild its industries and be able to pay its bills.

[9] If forward contracts implied the USD was in a multi-year declining trajectory, say by 2% annually, then UST yields would need to rise correspondingly (according to 'Interest Rate Parity'). However, a one-and-done event, like 1971 or 1985, does not require higher UST yields.

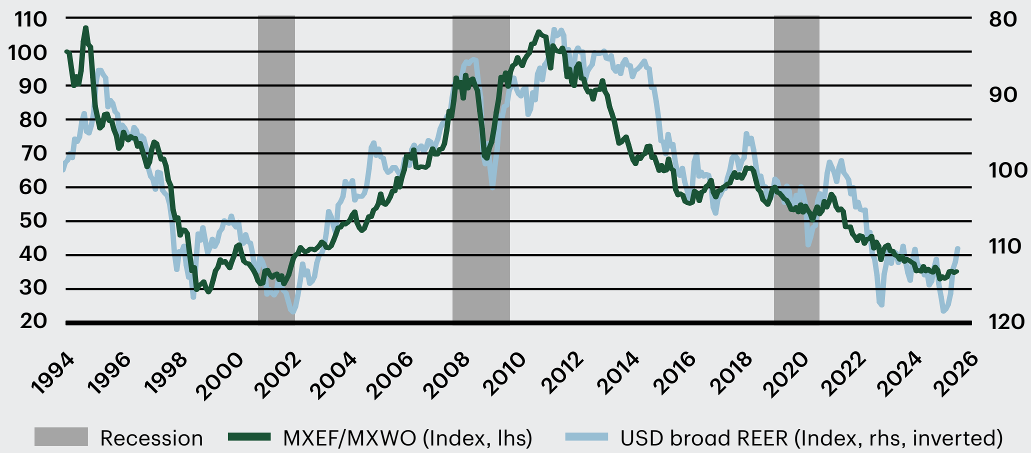
in the six months following both the 1971 Nixon shock and the 1985 Plaza Accord.[9]

Which equity markets would benefit most from a weaker USD?

How should equity investors tilt their portfolios if they expect a softer greenback? The key takeaway here is that a weaker USD means looser financial conditions, which tends to benefit cyclicals the most. To illustrate, there has historically been a very tight negative correlation between emerging markets (EMs) and the USD **(Figure 6)**. However, since 2012 this relationship has weakened, as Chinese equities have been increasingly driven by domestic policy priorities rather than global financial conditions. While China's weight within the MSCI Emerging Markets Index is currently 28% (it peaked at 40%), we don't think it is dominant enough to prevent the overall EM index from benefiting if the greenback weakens.

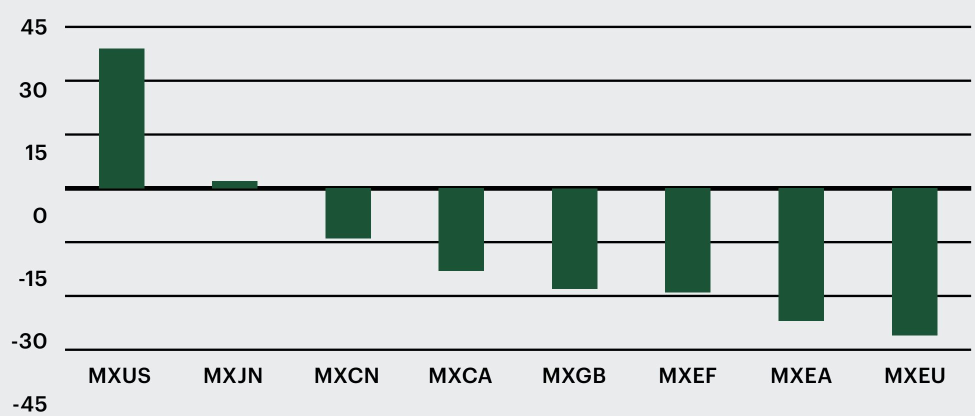
We now look more broadly at regional equity indices and S&P 500 sectors **(Figures 7 and 8)**. A weaker USD especially benefits cyclical regions and sectors. For example, the sectors with the most negative correlation include materials, industrials and energy, while defensive sectors such as healthcare, staples, telecoms and utilities possess positive relative correlations.

Figure 6: A weaker USD would provide a solid tailwind for emerging markets



Source: Bloomberg Finance L.P.

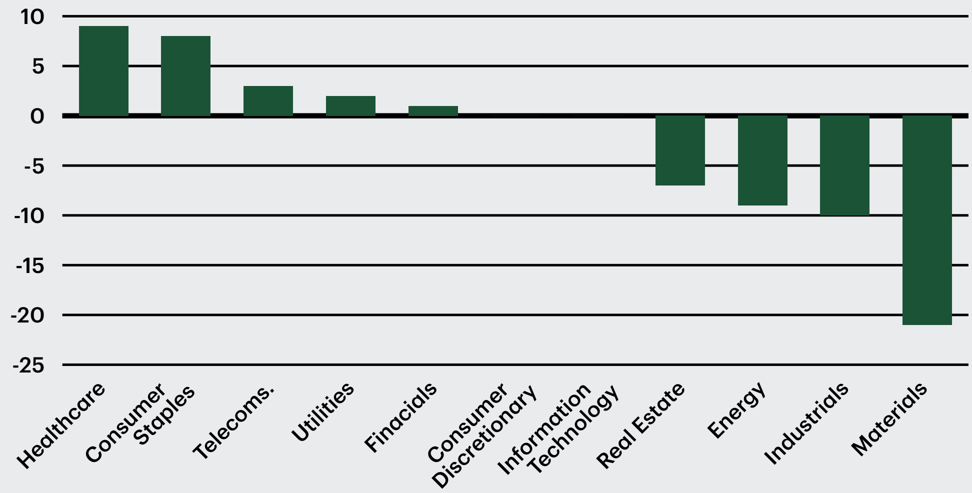
Figure 7: Correlations between the USD and regional equity indices (%, relative to the MSCI World Index, which itself has a correlation of -33%)



Source: Bloomberg Finance L.P.

Note: These indices are all USD-based, so that correlations across regions are comparable.

Figure 8: Correlations between the USD and S&P 500 sectors (%, relative to SPX, which has a correlation of -21%)



Source: Bloomberg Finance L.P.

Hedging for CAD-based investors

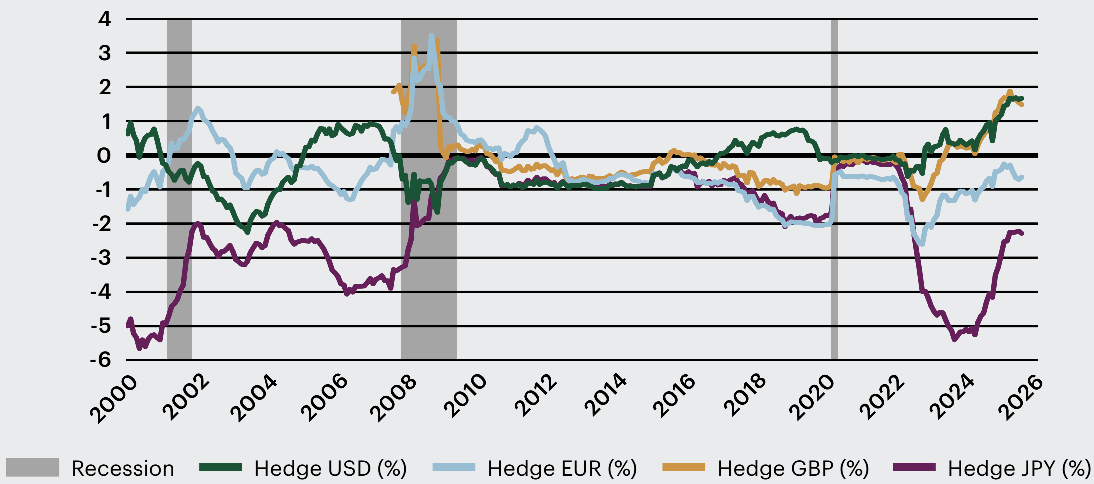
In addition to deciding how to tilt equity portfolios, foreign investors can choose whether to hedge or not. During the last decade, not hedging the SPX has typically yielded higher returns, and that certainly has been the case for CAD-based investors **(Figure 9)**. However, over the next few years we expect higher FX volatility, with USD/CAD likely to decline significantly. While some investors believe currencies mean-revert, so hedging is a wash over a reasonable time frame, Figure 9 shows that currency exposure can overwhelm, even over five-year periods. For this reason, we recommend that foreign investors consider a deliberate approach to hedging, which should be fully integrated into their investment process.

Figure 9: SPX unhedged returns exceed hedged returns when USD/CAD is rising

Source: Bloomberg Finance L.P.

When deciding whether to remain exposed to USD volitility, investors also need to take into account hedging costs. Currently, shorting USD is carry-punitive for CAD-based investors. In fact, their cost to hedge USD is now the highest it has been in decades **(Figure 10)**. This means, USD/CAD needs to decline by at least 2% per year for hedged returns to outperform. We believe this is likely over the next 3 to 5 years. Moreover, several studies have concluded that Canadian investors are highly exposed to U.S. equities and are broadly underhedged.[10] They are taking on a lot of FX risk, for which they are unlikely to be rewarded. All this speaks to the importance of adopting a deliberate approach to FX hedging.

Figure 10: Costs for CAD-based investors to hedge various currencies



Source: Bloomberg Finance L.P.

Note: Hedging costs are proxied here by: FGN 3M yield - CDN 3M yield

Conclusion: What would a weaker USD mean for investors?

This paper discussed several reasons why we expect a softer greenback. The fourth, that global rebalancing is a primary WH policy objective and requires a markedly weaker dollar, is the only one that is really new. And, naturally, such rebalancing will not occur in a predictable, linear fashion. This implies we've entered an era of higher FX volatility.

What is likely to be the catalyst for next USD down-leg? We believe it is when the WH begins to emphasize elements of Miran's agenda. This could include capital flow restrictions, debt swaps, currency intervention, greater coordination with the Fed, the establishment of a SWF, or negotiating a Mar-a-Lago Accord.

A softer USD corresponds to a loosening of financial conditions, which disproportionately benefits cyclical sectors (such as materials, industrials and energy) and regions (particularly EMs and the EU). However, we don't expect a weaker greenback to result in higher UST yields.

The USD has been on an upward trajectory for over a decade. During this time, not hedging has yielded higher returns for most foreign investors. However, we believe the past is not prologue, especially for CAD-based investors, who generally own a lot of USD-assets, but typically under-hedge. They are taking on a lot of FX risk, for which they are unlikely to be rewarded. We recommend such investors consider adopting a deliberate approach to hedging, which should be fully integrated into their investment process.

[10] See "How do Global Portfolio Investors Hedge Currency Risk?" by A. Cheema-Fox (State Street Associates) & R. Greenwood (HBS), 2024, as well as "Dollar Asset Holdings and Hedging Around the Globe," by W. Du (HBS) and A. Huber (Wharton), 2024. An analytical framework for CAD-based investors is presented in "Striking a Balance: The Optimal Hedging Ratio and Cost Trade-Offs in Global Currency Risk Management," by L. Viceira (Harvard) et al, 2023.

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